



## Missouri Bankers Association

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March 24, 2006

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RE: **FDIC** (No docket ID); **FRB** Docket No. OP-1246; **OCC** Docket No. 05-21; **OTS** Docket No. 2006-01; **Proposed Interagency Guidance on Concentrations in Commercial Real Estate**; 71 Federal Register 2302; January 13, 2006.

Ladies and Gentlemen:

The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the "Agencies") have proposed an Interagency Guidance on Concentrations in Commercial Real Estate ("Guidance") that raises the requirements for risk management by banks and savings associations that are deemed to have a concentration in commercial real estate ("CRE"). While not all commercial banks or savings associations are significantly

involved in commercial real estate lending, a large number of them – including many community banks in particular -- are. For the reasons outlined below, this Guidance may well have significant adverse impact upon the banking industry and local economies. Accordingly, we recommend that the Agencies not issue it in its current form.

The Missouri Banker Association (“MBA”) is a commercial bank trade association representing virtually all banks, trust companies, savings and loan associations, and savings banks located in Missouri. We appreciate the opportunity to comment on the proposed guidance regarding “Concentrations in Commercial Real Estate (CRE) Lending.” Missouri has not been an area identified with a significant concentration in the type of commercial lending you seek to isolate and focus on. While the undersigned’s experience in Texas and Oklahoma, make me cognizant of the various concerns that are mentioned in your proposal for comment, I believe they are not generally applicable to banks in Missouri.

### **General Comments**

Federal Bank Regulators apparently believe that the proposal merely restates what the current regulatory rules are. However Missouri bankers, bank regulators and bank counsel believe this proposal creates a whole new regulatory regime on commercial real estate and has many unintended consequences. These serious concerns, may be summarized as follows:

1. The new definition of a concentration in CRE includes several different types of CRE lending and establishes triggers for additional action without any attempt to distinguish the different levels of risk posed by each. This results in too many banks being deemed to have a high risk concentration in CRE.
2. Bankers will need to invest significant time, money, and effort to counter the assumption that they have an unsafe “concentration” of real estate loans. This is aggravated by confusing wording of the Guidance and the failure to reflect in the risk management practices differences in the size and CRE portfolios of different banks.
3. The Guidance strongly suggests that community banks deemed to have a concentration in CRE will be required to hold significantly higher levels of capital than other banks because of a conclusion that a large portfolio of CRE is inherently riskier.
4. Similarly, the Guidance suggests that banks with large portfolios of CRE should have significantly higher reserves for loan losses. Such increased reserves should follow only if a portfolio in fact presents a higher level of risk.
5. The Guidance may significantly reduce community banks’ ability to fund CRE in their communities, which will have a negative impact on the banks and their communities.

### **Recommendations**

The Agencies should not issue this one-size-fits-all Guidance. Rather, MBA recommends that the Agencies apply existing guidance on a case-by-case basis to address any problems in those banks not engaging in CRE lending responsibly.

If the Agencies do issue additional CRE guidance, then MBA urges that the Guidance be modified. First, it needs to focus on those institutions that are causing concern for the Agencies, namely, those institutions with a genuine high-risk concentration in CRE. The Guidance should not apply to loans that are clearly not high risk. For example, the carve-out in the Guidance of "owner-occupied" loans should include loans where real estate serving as collateral is subject to a contract for the construction and purchase of the property and loans made directly to the eventual owner of the house, as these are significantly less risky than speculative building.

Second, the initial concentration limits are too low to justify the greatly increased scrutiny. MBA recommends that the initial screen should be raised to 200% of a bank's total capital.

Third, MBA recommends that the Guidance state more clearly how the specific requirements for management information systems and monitoring of the CRE portfolio may be scaled down for smaller banks and/or banks with narrowly focused CRE portfolios, such as primary residential housing construction.

Finally, MBA recommends that the proposed Guidance provide more detail concerning when higher levels of capital and/or of reserves would be required by examiners. The Agencies should not impute higher risk levels just on the basis of a finding of a concentration (as it is newly defined in the Guidance) in CRE lending. It would be better if the Agencies addressed the needs for more capital or larger reserves on a case-by-case basis as part of the supervisory examination process rather than through an overly broad approach to reining in CRE lending.

#### **Missouri State Bank Regulator's Comments**

The Missouri Division of Finance has also made itself known on this issue. Commissioner McClure made the following comments available: "Missouri is against the Interagency Proposal on the Classification of Commercial Credit Exposures primarily because it is redundant and will add to the regulatory burden of many of our banks."

"This proposal if enacted will immediately require 91 of our state chartered banks to re-write real estate loan policies, segregate and identify all real estate loans, possibly establish reserves for concentrations, increase regulatory capital requirements. Our Chief Examiner has noted that the number of affected banks would increase over time as the trend for community banks is to become more involved in commercial lending."

"The proposed guidance addresses board and management oversight, strategic planning, underwriting practices, risk assessment and management, and capital adequacy. The is

admittedly a move toward safety and soundness; however, these issues are already covered in our regulatory examinations. It could cost Missouri banks an incredible amount of money and time if this guidance prevails. This proposal also suggests the two dimensional classification system that has been shelved which state regulators opposed last year. Banking institutions are already highly regulated and this beltway proposal would more than likely prove overly burdensome for the industry in relation to any benefit. **The concern about over concentration in commercial real estate is best left to individual bank examinations.(emphasis added)**”

### **Other Unintended Consequences**

The Missouri Bankers Association is working with Missouri’s State Treasurer to expand placement of public funds in Missouri depository institutions. The bankers were successful in passing SB 270 that encourages both banks and the state treasurer to place public funds in depositories. In 2005, the formal list of collateral for public funds was substantially increased so that mortgages may serve as collateral for public funds. This public funds collateral is found in section 30.270.1 (16) and permits as collateral the following:

“(16) (a) Mortgage securities that are individual loans that include negotiable promissory notes and the first lien deeds of trust securing payment of such notes on one to four family real estate, on commercial real estate, or on farm real estate located in Missouri or states adjacent to Missouri,…”.

When federal bank regulators expand, perhaps even exaggerate, risks associated with commercial loans in a mechanical lock step fashion, other uses of such mortgages are undermined and MBA’s efforts to encourage the use of these securities as collateral for public funds are set back.

### **Analysis**

#### 1. Definition of a “concentration in commercial real estate lending”

Central to the application of the proposed Guidance is the definition of a “concentration in commercial real estate.” This raises two fundamental issues: First, what is a “commercial real estate loan”; and second, what level of CRE lending represents a “concentration”?

#### (a) The definition of CRE

CRE is defined by the Agencies as –

exposures secured by raw land, land development and construction (including 1–4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

The Agencies exclude loans secured by owner-occupied properties from the CRE definition as having a lower risk profile.

This definition blends various loans secured by commercial real estate into essentially one risk bucket, which ignores the very different risk profiles of some types of CRE-secured loans. First, there is no differentiation between (a) retail and office commercial real estate loans and (b) 1-4 family residential construction loans. Construction loans for income property pose significantly higher risks than do 1-4 family construction loans. Second, there is no differentiation between 1-4 family residential construction that is built “on speculation” from 1-4 family residential construction where the contractor already has a contract for the house (a custom home contract). Losses on custom home contracts are very low and should not be in the same risk category as “spec housing.”

The Guidance also inappropriately includes within the definition of CRE loans those loans that are made directly to consumers for construction of new housing. As we read the Guidance, the 100% threshold for a concentration of CRE does not treat these as owner-occupied. For some institutions, this type of lending is significant and its inclusion in regulatory guidance specific to CRE results in a significant distortion of the level of commercial construction risk relative to peer institutions. These direct-to-consumer construction loans are different from CRE because:

- These loans are generally originated for sale and underwritten to secondary market standards. The loans are classified as held for sale and generally sold to investors upon completion of construction.
- While there is construction completion risk, there is virtually no real estate market risk. The owner-occupants are responsible for repayment, and the loans are underwritten to permanent financing standards.

Loans made directly to consumers are more appropriately considered real estate loans instead of commercial real estate loans. The agencies acknowledge the lower risk in the former type of loan as the supervisory loan-to-value ratio limit for owner-occupied 1-4 family construction to permanent loans is 90%.

For all of these reasons, MBA recommends that the CRE definition be amended to distinguish clearly the risks between 1-4 family residential construction loans (particularly when they are “custom-built” loans or “owner-occupied” loans) and other commercial real estate loans. At a minimum, the Agencies should consider specifically excluding owner-occupied commercial real estate construction loans from the 100% threshold, in order to be consistent with the 300% threshold test for CRE, which acknowledges the fact that the risk profiles of these loans are less influenced by the condition of the general CRE market.

(b) The appropriateness of the thresholds

The Guidance sets forth the following two supervisory thresholds, either of which may trigger greater scrutiny, greater risk management requirements, greater loan loss reserves, and greater capital:

(1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution's total capital. Institutions exceeding threshold (1) would be deemed to have a concentration in CRE construction and development loans and should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance.

(2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution's total capital. Any institution exceeding threshold (2) should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan contained in this Guidance. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices that are consistent with the Guidance.

Bankers are concerned about the relatively low threshold for determining when CRE concentrations present a higher risk. The Guidance sets an initial threshold of 100% of total capital for certain types of CRE. Previous limits on real estate lending set a threshold of 100% of total capital for loans secured by real estate **that were in excess of the supervisory loan-to-value ratio**. Total loans in excess of the supervisory LTV limits "for all commercial, agricultural, multifamily or other non-1-to-4 family residential properties" were also limited to no more than 30 percent of total capital. As we understand the proposed Guidance, it is now possible for an institution to have **no** real estate loans over their appropriate LTV, yet trigger a presumed level of higher risk in CRE lending. This appears to be a significant shift in supervisory concern not clearly justified by the Agencies.

## 2. The burden on banks to counter the assumption of an unsafe concentration of CRE

After determining that the bank has a concentration of CRE under the new thresholds, the bank must ensure that it has "heightened risk management practices that are consistent with the Guidance." All of the bankers we have consulted agree that high levels of CRE require heightened risk management, and they believe that they do in fact have such risk management. However, few community banks have all of the recommended risk management practices in place, and none believes that all of the practices set forth in the Guidance are justified for the CRE lending that they are doing. These banks are following existing real estate lending guidance, rather than this proposed Guidance that requires more detailed risk management practices and is aimed at institutions that actually pose higher risks in their CRE lending. There appears to be no attempt in the proposed Guidance to scale the regulatory response to the size of the bank or the particular composition of its portfolio. This creates a "one size fits all" approach inconsistent with recent regulatory initiatives in examination and supervision. For example, in the recent

ANPR on Modifications to Domestic Capital Standards (Basel IA), the Agencies suggest that it would be appropriate to further lower the risk weight of home mortgage lending. But this Guidance includes direct-to-consumer mortgage construction lending as higher-risk CRE.

The Agencies state in the preamble to the Guidance that

Recent examinations have indicated that the risk management practices and capital levels of **some** institutions are not keeping pace with their increasing CRE concentrations. In **some** cases, the Agencies have observed that institutions have rapidly expanded their CRE lending operations into new markets without establishing adequate control and reporting processes, including the preparation of market analyses.

Thus, it appears that the proposed Guidance is meant to be focused on a few institutions. However, the way it is written suggests that examiners are to apply the Guidance with greater rigor to **all** institutions, not just the **some** that prompted the Agencies to propose the Guidance.

The extensive requirements set forth in the Guidance may be overwhelming for a community bank. Examiners will be asking for the bank's reports on market conditions, evidence of increased board oversight, production of new policies, more detailed strategic planning, quantifiable limits, contingency plans, feasibility studies, sensitivity analysis, stress-testing, tracking presales and more. Examiners clearly may apply this Guidance in a way that substantially increases the regulatory burden on community banks with limited staffs, and they may well feel that they are required to do so by the terms of the Guidance. MBA believes that the application of the Guidance to all banks is excessive and that the full array of measures it requires should be reserved for those few banks that have problems in the risk management of their portfolios, whether it be CRE or any other concentration of lending.

All of these burdens likely will be compounded by the Guidance being unclear in several places. For instance, it is not clear whether the different thresholds for determining CRE concentrations require different responses. Under threshold (1), an institution "should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance." Under threshold (2), an institution "should have heightened risk management practices that are consistent with the Guidance." The key appears to be that under threshold (1), an institution must determine its degree of CRE concentration risk and then apply appropriate risk management practices. This may allow institutions to determine that they have a lower risk rate in their portfolios of 1-4 family residential construction loans or in direct-to-consumer loans than if they have a concentration in office construction. However, the Guidance is not clear that banks may do this. This may lead to a heightened but uneven examination scrutiny of banks' risk management practices, as different examiners arrive at different judgments of an institution's "degree of CRE

concentration risk” and require significantly different levels of risk management risk practices to similarly situated institutions.

The organization of the Guidance adds to the confusion. First the Guidance gives a special definition of CRE. Then the Guidance gives two different thresholds for a concentration in commercial real estate lending based on Call Report (or TFR) items that do not use the special definition of CRE. Then it provides that for threshold (2), but not for threshold (1), bankers should examine their loans reported in the Call Report using the new definition of CRE to reduce the amount of loans included in threshold (2). This is backwards. The special definition of CRE should follow the explanations of the thresholds, and be clearly shown to apply only to the calculation of the final amount for the 300% threshold.

The Guidance excludes “owner-occupied” properties from the final calculation of threshold (2), but the Guidance does not define “owner-occupied” and neither do the Call Report instructions. Is a loan to a contractor who is building the house under a contract for sale on completion “owner-occupied”? We believe it should be so termed. Are business premises that will be occupied by the owners but will also have commercial or even residential leases considered “owner-occupied”? Is it owner-occupied only if the owners occupy 25% or 50% or 75% or more of the building?

Bankers will need to invest significant time, money, and effort to counter the assumption that they have an unsafe “concentration” of real estate loans. This is aggravated by incomplete and inconsistent Guidance and the lack of scaling of the risk management practices required to banks of different sizes and different CRE portfolios. **We believe that the net effect of the Guidance as it is currently written will be excessive burden on community banks.**

### 3. Increased capital requirements

A concentration in any line of lending requires greater risk management as the concentration in the line increases. However, community bankers tend to focus on one or two major lines of lending in order to be sure that they have the expertise on hand to manage the risk in that lending. The Guidance would appear to have the effect of penalizing banks – by requiring capital at levels that may be inappropriately high – that have focused their resources precisely to ensure that they can compete in a safe and sound manner.

Higher levels of CRE lending appear to be a logical evolution for community banks. As former Federal Reserve Board Chairman Alan Greenspan said in a speech in early 2004,

Particularly noteworthy is the longer-term trend at community banks that seems to have accelerated in the past three years--the increasing share of asset growth accounted for by nonresidential real estate finance, particularly construction and land development loans and commercial and industrial real estate financing. Last year these categories accounted for more than 90 percent of the net asset growth of banks with less than \$1

billion in assets; multifamily real estate and farmland finance would bring the total to more than 100 percent, offsetting the declines in other categories.

Such credit exposures are a natural evolution of community banking and are quite profitable, helping to sustain both the earnings and growing equity capital of community banks. Moreover, the evidence suggests that community banks have avoided the underwriting mistakes that led to so many problems ten to fifteen years ago. Borrower equity is much higher and credit criteria are much stricter. In the last recession and during the early weak recovery, we saw very few delinquencies in these credits. Nonetheless, bankers need to be aware of the historical real estate cycle that, in the past, placed such exposures under severe stress. One hopes these improvements in underwriting standards are lasting. But the painful lessons of banking history underscore the ever-present need for vigilance in managing geographic and business line concentrations.

Community bankers do not argue against the need for vigilance in managing geographic and business line concentrations. But they do argue against the arbitrary demand for additional capital that may result from the Guidance. Regardless of the intent of the Guidance, the risk is that the Guidance will lead to inappropriately higher capital levels. The Guidance states that –

Minimum levels of regulatory capital do not provide institutions with sufficient buffer to absorb unexpected losses arising from loan concentrations. Failure to maintain an appropriate cushion for concentrations is inconsistent with the Agencies' capital adequacy guidelines. Moreover, an institution with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures.

Our bankers unanimously read this as an instruction to examiners to demand more capital in the event that the examiner determines that there is a concentration in CRE. They see this as unrelated to how well the institution is managing its CRE portfolio, how low losses have been, what reserves have already been taken, and all of the other factors that should weigh on a determination of the need for additional capital. True, at the end of the discussion on capital adequacy, the Agencies state "In assessing the adequacy of an institution's capital, the Agencies will take into account analysis provided by the institution as well as an evaluation of the level of inherent risk in the CRE portfolio and the quality of risk management based on the sound practices set forth in this Guidance." However, community bankers wonder if they can provide the kind of risk analysis that examiners will accept as mitigating this perceived higher risk. In short, bankers see this Guidance as a demand for higher capital at concentration levels that are really designed for triggering heightened risk management review rather than higher levels of capital.

The Agencies already have authority to demand higher levels of capital from any institution, if they determine that the institution has accumulated significantly higher risks than its peers or is otherwise acting in a manner that is inconsistent with existing guidelines. Here the Guidance appears to move past that authority into creating an inherent need for additional capital for any concentration of CRE. Bankers believe that this sets far too low a trigger for requiring additional capital and ignores their current risk management practices. They urge that the Agencies drop this discussion of the need for additional capital and rely instead on existing authority, guidance and policies as the basis for a case-by-case determination of any need for additional capital.

#### 4. Higher levels of reserves for loan losses

The Guidance appears to create a *per se* assumption that banks with large portfolios of CRE should have significantly higher reserves for loan losses because of a presumed greater level of risk presented by the CRE. However, many banks report little or no loss in their CRE portfolios, and they question the validity of singling out CRE for additional reserves. The Agencies, in the preamble to the Guidance, state that “[i]n the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system. Banking today is different than it was in the mid-eighties. We now have new capital requirements, more stringent real estate lending and appraisal requirements, express limits on high LTV real estate loans, and better supervisory examinations. As the Agencies note in the preamble, overall underwriting is better, largely due to the existing Agency guidance on real estate lending and the application of supervisory loan-to-value (LTV) ratios and limits on loans in excess of those ratios. Therefore, to blanket all banks with the requirements in the Guidance based on a newly crafted ratio, when there is no other evidence of weakness in capital or management, seems unjustified.

The assumption that there is a higher risk in a CRE portfolio ignores the risk presented by lending alternatives. Unsecured C&I loans, inventory financing, credit card lines, loans for consumer chattels -- none of these appear to be inherently less risky than CRE lending. Unlike these other types of loans, loans secured by mortgages on real estate will still have value in the property upon recovery even if the property deteriorates or the appraiser overestimated the property value. In even the worst case, only part of the principal will be lost.

By highlighting CRE and newly defining concentrations in CRE, the Agencies seem to be urging a higher reserving that previous guidance and policy do not appear to support. Worse, it may be at odds with recent guidance on reserving from the AICPA, which places the community bank squarely between its regulator and its auditors. At a minimum, this part of the Guidance needs to be clarified by better explanation of the connection of the Guidance to the existing Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.

#### 5. Impact on small banks and their communities.

Finally, and most importantly, MBA is concerned about the probable impact of the proposed Guidance on small banks and their communities. Community bankers already find themselves unable to compete in various consumer lending businesses, lacking the scale to make credit card or auto lending profitable and sometimes unable to compete against the largest national mortgage lenders. Many have become larger lenders in the CRE market as a natural evolution of the banking market, as former Chairman Greenspan observed. This willingness to support business expansion in their communities has been crucial to economic recovery over the last few years in a number of communities.

The implication in the Guidance that there will be major increases in capital requirements and loan loss reserves, as well as major additional demands on banks' officers and lending personnel to provide in-depth market analysis, stress testing analysis, and other analyses relating to possible negative effects of CRE concentrations, leads many banks to believe that they may well have to significantly curtail their CRE lending. As CRE lending has been one of few remaining major profit lines for community banks, they are deeply concerned about the negative impact of this Guidance on them and, consequentially, on their communities.

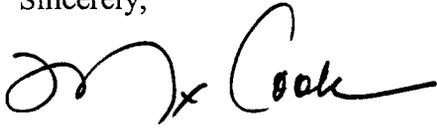
## **Conclusion**

As community banks have been forced to consolidate lending due to national competition (in credit cards, mortgage lending and auto lending, as examples), local commercial real estate has been one of the strongest products for community banks. Their knowledge of their communities and markets affords community banks a significant advantage when competing for CRE loans. To now have stricter guidelines regarding commercial real estate imposed on all of them appears to increase the costs to all community banks making CRE loans while only peripherally addressing any problem banks. The MBA has incorporated most of the American Bankers Association comments, as focused and pertinent to CRE in Missouri banks as well. **There is a real question whether there is a need for these need guidelines applied to across the industry.**

Those consequences are the nature of lending Guidance such as this to result in a period of constriction while examiners and bankers work out new understandings of the instructions they've been given. Such a result will not benefit community banks or their communities, and apparently is not be what the Agencies intend. MBA recommends that the Agencies carefully reconsider issuing this Guidance and instead rely upon current guidance and policies during examinations to rein in those few banks that are causing the Agencies' concerns about CRE lending.

If the Agencies continue with issuing this Guidance, MBA strongly urges the Agencies to thoroughly revise the Guidance to eliminate the areas of confusion and concern that it has created for community banks. Failing to do so would be a disservice to the Agencies' regulated institutions and to the communities these banks serve. If you have any questions about these comments, please call the undersigned.

Sincerely,

A handwritten signature in black ink, appearing to read "Max Cook". The signature is fluid and cursive, with a large initial "M" and a long horizontal stroke at the end.

Max Cook  
President